



## Briefing Note

# STATE AIDS RULES

## Association Agreement 2011

Prepared by the EIPA Project

All intellectual property rights reserved

The EIPA Project supports Ukrainian Government to develop the mechanism for closer European Cooperation and good governance.

The material presented in the brochure is the opinion of the experts only.

The project is funded by the UK Government's Strategic Programme Fund



# State Aids Rules

## Key issues

*The aim of the agreement between Ukraine and the EU is to foster their gradual integration politically, economically and legally.*

*The DCFTA aims at the progressive integration of Ukraine into the internal market of the European Union.*

## What is Association Agreement?

The European Union concludes a variety of agreements with non-EU countries; international agreements which are now covered by articles 215-219 of the Treaty on the Functioning of the European Union (TFEU).<sup>1</sup> Association is a specific and developed form of cooperation implying 'reciprocal rights and obligations, common action and special procedure' (art. 217 TFEU).

In addition, article 8 of the Treaty on European Union (TEU) lays down the need for the EU to develop 'a special relationship with neighbouring countries'.

In Europe the EU used the negotiation of Association Agreements in the early 1990s to help the countries of Central and Eastern Europe to progressively integrate with the EU prior to their accession. Very similar agreements are now being offered to the countries of Eastern Europe.

Ukraine and the EU are approaching the end of a long negotiation to conclude an Association Agreement between them, which will include a deep and comprehensive free trade area (DCFTA).

Association Agreements with eastern European countries of course will vary depending on the state with which the EU is negotiating. However the aims and structures of the agreements are liable to be quite similar.

The aim of the agreement between Ukraine and the EU is to foster their gradual integration politically, economically and legally.

On the political level there will be greater cooperation and consultation between the governments of Ukraine and the European Union institutions and member state governments and between the Ukrainian Parliament and the European Parliament. New institutions will be created by the agreement, once it is ratified, in which all issues of mutual interest or indeed disputes about the working of the agreement can be discussed. The Association Council, consisting of ministers from both sides, will be able to take legally binding decisions with respect to the matters dealt with in the agreement.

Economic integration will be fostered by the introduction of European Union law into the legal code of Ukraine. The economic aims of the agreement are therefore not only the creation of free trade between the two sides, but assistance to the reform of the Ukrainian economy, introducing more

---

<sup>1</sup> The Treaty on the Functioning of the EU and the Treaty on European Union form the basic law of the EU



## EIPA Briefing Note on State Aid Rules EU-Ukraine Association Agreement 2011

*With more competition in the economy and easier access to European Union markets, the economy should become more efficient and more productive.*

competition and greater transparency. The DCFTA aims however at the progressive integration of Ukraine into the internal market of the European Union. This will be a progressive process because it requires a degree of harmonisation of economic law and standardisation, but the future benefits to the Ukrainian economy and its citizens could be very considerable.

The potential gains for the Ukrainian citizen from the full implementation of the Association Agreement once ratified are considerable. With more competition in the economy and easier access to European Union markets, the economy should become more efficient and more productive with all the benefits that that suggests for income levels and employment. But beyond this, the agreement will open up wide areas of cooperation to encourage exchanges of people, ideas and skills. Although not part of the Association Agreement, the parallel process of visa facilitation and working towards eventually visa-free travel between Ukraine and the EU. will produce new benefits for Ukrainian society.

The Association Agreement between Ukraine and the European Union can therefore be understood as a major support for Ukraine's own reform agenda. It is true that certain groups in society may not benefit from the implementation of the agreement but what cannot be doubted is that Ukrainian citizens as a whole will gain in terms of higher living standards, more and wider employment opportunities and better opportunities for their children.

### ***What is the purpose of the policy?***

*State aid control is one of the core elements of EU competition policy to guarantee a level playing field for all European companies in the EU Internal Market.*

State aid control is one of the core elements of EU competition policy. Its aim is to minimize market distortions caused by state financial intervention and to guarantee a level playing field for all European companies in the Internal Market. EU state aid regulation governs state aids liable to affect trade and competition between member states. However EU member states have national authorities overseeing state aid, which also ensure fair competition even when an aid has exclusively national impact.

Ukraine has vast experience of giving state support to its companies. Establishing a system of State aid control and seeing to it that the aid is not distorting trade relations, is an external requirement to which Ukraine has committed itself as a result of WTO membership and association negotiations with the EU. While the Ukrainian laws regulate who receives how much state support and why, the control mechanism of public financial support will in essence follow the *acquis communautaire* of the EU.

Being an important element of internal market regulation, State aid control still remains a less obvious instrument in the EU Member States. Partly it is because of the legal complexity and technical nature of this area of legislation, and partly because it is not a politically attractive subject, as it restricts support to national businesses. We argue that for Ukraine, State aid control can



## EIPA Briefing Note on State Aid Rules EU-Ukraine Association Agreement 2011

*As a result of WTO membership and association negotiations with the EU to establishing and implementing State Aid control.*

*State aid reform can contribute to domestic reform by delivering more efficient and transparent public spending, better equipped civil servants and an improved business environment.*

European competition law aims to guarantee a level playing field for all European companies in the Internal Market.

State aid means conferring certain benefits by public authorities to undertakings through state resources in any form.

increase efficiency in the economy and reduce waste through inefficient state subsidization. Next to rather obvious forms of aid like direct state subsidies and tax breaks, there are less obvious forms of aid, for example state guarantees, sale of public property under the market price or purchase of goods and services against higher prices than the market price. All of these can also distort competition. *The aim of this short paper* is to demonstrate why Ukrainian authorities should pay attention to the full range of State aid measures (meaning all types of direct and indirect benefits that the state transfers to businesses). Setting up a legal framework for State aid control is surely important for Ukrainian commitments towards the EU. However, if one systematically identifies the 'less obvious' forms of State aid and includes them in the routine of (competition) policymaking, Ukraine can benefit even more. State aid reform can contribute to domestic reform by delivering more efficient and transparent public spending, better equipped civil servants and an improved business environment. In order to reach this, simultaneously with the setting up of a legal framework, attention has to be paid to practical implementation of State aid control at all levels of government.

### ***Why are there State aid rules and what is State aid?***

There are many reasons for European competition law. The most important is to guarantee a level playing field for all European companies in the Internal Market. Too much subsidy can distort competition between companies. State aid control also prevents unnecessary public expenditure: nobody wants a subsidy race between authorities! Preserving competitive markets is the best way for European citizens to get the products they want at low prices, and to foster innovation and growth in the EU. Finally, there is a lot of money involved in regional policy of the European Union. State aid control must safeguard that cohesion subsidies are spent on a fair basis.

State aid measures come in a wide variety and differ according to national practice. However, in essence it is all about public authorities conferring certain benefits to undertakings through state resources in any form. As a result, some companies are better off than their competitors who have not benefited from the state intervention. Of course, a subsidy, a gift or a tax break is the most obvious public financial instrument. Less obvious forms of aid are:

- A firm buys/rents publicly owned land or buildings at less than the market price;
- A company enjoys privileged access to infrastructure without paying a fee;
- An enterprise obtains risk capital (finance provided through equity financing to undertakings during their early growth stages) from the State on terms, which are more favorable than it would obtain from a private investor;
- A public authority issues a guaranty to a firm without receiving a



## EIPA Briefing Note on State Aid Rules EU-Ukraine Association Agreement 2011

- reasonable premium in return;
- A public authority invests in a company or enters a public private partnership under conditions which would not be acceptable to a private investor;
- A public authority pays more than a reasonable price for a (public) service.

The Treaty of the Functioning of the European Union (TFEU) takes a clear stance on State aid. State aid, as a general rule is prohibited if it distorts competition and affects trade between member states. A certain measure constitutes State aid if all of the following criteria are met:

- it is granted through State resources in any form whatsoever;
- it provides an advantage that distorts competition;
- it favours certain undertakings or the production of certain goods;
- it affects trade between Member States.

Certain forms of aid are allowed under the Treaty. The main categories of permissible aid are:

- regional aid for disadvantaged geographical areas,
- horizontal aid<sup>2</sup> for e.g. environmental protection, research, development and innovation, access to venture capital and investment in SME's,
- sector-specific aid for agriculture, fisheries, transport and several other sectors<sup>3</sup> and
- small volume aid coming under the de minimis rules.

In order to ensure transparency, predictability and legal certainty the Commission has published criteria for deciding whether aid measures qualify for exemption. These publications have taken the form of a huge stack of communications, frameworks, guidelines or letters to Member States. The allowable aid is limited: the crux is that no more State aid should be given than necessary in order to achieve Community market or equity objectives, in circumstances where the market fails to properly provide.

### ***Where does Ukraine currently stand?***

*In 2002, Ukraine was spending about 2 % of its GDP on State aid to industries, as opposed to the total of 0,6 % of GDP in EU-25.*

The restrictions on State aid in the EU might put European companies in a disadvantaged position in the global competition with economies where state aid is tolerated. Therefore, the European Commission promotes 'the export' of State aid rules beyond its borders, among other things, through Free Trade Agreements.<sup>4</sup>

In 2002, Ukraine was spending about 2 % of its GDP on State aid to industries, as opposed to the total of 0,6 % of GDP in EU-25. Two thirds of the Ukrainian

<sup>2</sup> Rules on Horizontal State aid address problems and challenges that may arise in any industry or region.

<sup>3</sup> For an overview of the basic principles of State Aid control see the [website of the European Commission](#) ; see also Begunski, L., 'Creating a system for monitoring and control of State aid to Ukraine', Kiyiv, 2010.

<sup>4</sup> Blauburger, M., R.U. Krämer, '[European Competition vs. Global Competitiveness: Transferring EU Rules on State Aid and Public Procurement beyond Europe](#)', CCP Working Paper 10/2010, University of East Anglia.





## EIPA Briefing Note on State Aid Rules EU-Ukraine Association Agreement 2011

aid was spent on specific sectors of economy and only a few percent on horizontal types of aid like boosting environmental protection or innovation. Due to absence of a formal definition of State aid in Ukrainian legislation, it is very difficult to determine the scope of less obvious types of aid hidden in such transactions as state guarantees or sale of public assets. The total amount involved might be much higher. It has been argued that the current system of state aid in Ukraine is not transparent and is ineffective.<sup>5</sup>

By signing the PCA, Ukraine committed itself to refrain from State aids ...which distorts competition in so far as they affect trade between the Community and Ukraine (art. 49.2.2 and 49.2.3). It means adopting State aid legislation, including in particular: a definition of State aid compatible with that of the EU and the establishment of transparency as regards State aid granted in Ukraine (by establishing a list of all aid grantors and an independent surveillance body, a regular report on the amounts, types and recipients of aid). While shaping the legal framework, Ukraine has experienced several setbacks. Both the initiatives to draft a new law on State aid (2004) and to amend the Law on Protection of Economic Competition (2007) failed in the Parliament.<sup>6</sup> In 2010, the Commission had to admit that the State aid reform was not moving forward.<sup>7</sup>

*Ukraine is now in an advanced phase of the Deep Free Trade/ Association Agreement negotiations with the EU and State aid reform is part of that.*

Ukraine is now in an advanced phase of the Deep Free Trade/ Association Agreement negotiations with the EU and State aid reform is part of that. In 2010, the authorities have progressed towards the preparation of law on State aid control. The program of economic Reform (2010-2014) of June 2010 estimates that the law should be adopted by 2011. The Cabinet of Ministers has approved the concept of reform of State aid system (Resolution No 81/2010)<sup>8</sup>. In January 2011, an inter-agency Working Group on Developing of Draft Law of Ukraine 'On State Aid to Business Entities' started its work. So, there is progress in setting up the required legal framework.

However, changing the law because of requirements 'from outside' is only one side of the story. Controlling public finance with fair competition in mind is also beneficial to the internal transition of the country: it makes the use of public resources more efficient; it can improve the government capacity to deal with businesses and positively contribute to the business environment within the country. When these benefits are made more prominent in the reform process, it ought to be easier to 'sell' the necessity to adapt to external, EU requirements. This can be summed up in the scheme below:

<sup>5</sup> 'Free Trade between Ukraine and the EU: An impact assessment', International Centre for Policy Studies, Kyiv, 2007, p. 197, Blauburger, M., R.U. Krämer, p. 922.

<sup>6</sup> Freyburg, T. et al (2009) 'EU promotion of democratic governance in the neighbourhood', Journal of European Public Policy, 16:6, 916 — 934.

<sup>7</sup> ['Taking stock of the European Neighbourhood Policy \(ENP\) Implementation of the European Neighbourhood Policy in 2009'. Progress Report Ukraine](#); European Commission, 12/05/2010, sec(2010) 524, p. 10-11.

<sup>8</sup> Begunski, L., 'Concept of Ukrainian Law on State Aid Control', 2010, p.1



## EIPA Briefing Note on State Aid Rules EU-Ukraine Association Agreement 2011

	External requirements	Internal transformation
<b>Legal approach</b>	EU/ WTO requirements to remove trade distortions	Legislative framework State aid monitoring and control authority
<b>Policy implementation</b>	State aid policy in place Monitoring and reporting	Efficiency and transparency of public spending Better equipped government officials Improved business environment

### Benefits and risks of State aid control

*Benefits of implementing a proper State aid control in Ukraine can be summed up in three major points:*

*1) it's a more efficient use of state resources and greater transparency.*

*2) knowledge of State aid rules can make civil servants better equipped in dealing with both local and foreign enterprises*

*3) putting State aid control in place can greatly improve the business environment in the country and trust in government.*

Benefits of implementing a proper State aid control in Ukraine can be summed up in three major points. First of all, it's a more efficient use of state resources and greater transparency. If government officials want to be aware of the full scale of disadvantages of State aid, they have to realize that 'any financial transaction' can lead to State aid: not only direct subsidies but also government participation in investment projects, public private partnerships, urban regeneration projects, privatization, transfer of intellectual property rights etc. This 'State aid reflex' makes officials think about the most efficient use of state resources and limit favours to certain companies, which the authorities might not be aware of. State aid legislation also helps keeping public services efficient. For example, a company runs a rural bus service and is subsidized by the local authority for keeping the prices low and linking remote villages. If the company is traditionally not used to disclosing a complete structure of costs and revenues, the European State aid rules on services of general economic interest can be used as a benchmark, even if EU state aid rules do not apply; they include criteria which help making sure that no more public money is spent than the actual costs of this service.

A State aid control mechanism demands larger transparency of government spending. Regular monitoring and reporting gives insight into the amounts of aid and the companies who benefit from it. Transparency, in its turn, contributes to the credibility of public authorities. Besides that, through greater transparency, the State aid control can contribute to limitation of corrupt private/government links. Last but not least, effective State aid control at all levels of government can contribute to a better image of public administration.

Secondly, knowledge of State aid rules can make civil servants better equipped in dealing with both local and foreign enterprises (including their well informed lawyers) and effectively control co-operation projects, privatization or investments. This concerns especially less obvious forms of State aid like sale of land. For example, in urban regeneration projects, private developers can be inclined to demonstrate a bigger project funding gap than absolutely necessary, so that they can maximize the amount of public subsidy for a project and their profit margin. Thinking in terms of State aid and using State aid control methodology, civil servants can have instruments to limit the aid to the



## EIPA Briefing Note on State Aid Rules EU-Ukraine Association Agreement 2011

minimum amount which is necessary for a project to happen. If a project generates more profit than foreseen, the private partners have to pay the excess amount back to the public authority. In short, State aid rules help to limit the ambitions of some private parties to exploit tax money to their own benefit.

Thirdly, putting State aid control in place can greatly improve the business environment in the country. It increases transparency and predictability in relations between government and business and boosts mutual trust. Further, State aid rules stimulate the EU Member States to organize open tender procedures in order to prevent unlawful aid. Obviously, an open tender helps finding out the market price and prevents certain firms from receiving unfair benefits. Moreover, bigger awareness of State aid among businesses and the public helps the system control itself: well aware companies can use their legal rights to challenge unlawful State aid to their competitors in the national court. This has become a common practice in the EU Member States.<sup>9</sup>

Providing unlawful State aid can lead to a breach of trust between the authorities and companies.

Two policy priorities of the EU State aid should be mentioned here. Since the State aid reform started in 2005, the Commission has pushed Member states towards a re-orientation from aid to specific sectors of the economy towards forms of aid which distort competition less. For example, horizontal aid (aimed at solving problems that may arise in any industry and country) has become a priority. It means focus on aid for research, development and innovation, environmental protection, small and medium sized enterprises, investing in human capital (employment and training aid) and aid to SME's. The Commission is also shifting the accent towards the evaluation of the economic effects of State aid measures: do they really reach the goals of common interest, like greater employment, cohesion or more R&D. Is the effect on trade limited?<sup>10</sup> Although Ukraine and the majority of EU countries are at different levels of economic development, the priorities for horizontal assistance and economic effects of aid remain relevant.<sup>11</sup>

### *Risks associated with non-compliance to State aid legislation*

Paradoxically, granting State aid does not pose more financial risk to the government than any other financial transaction. The risk is on the side of the company which benefits from aid: in the worst case, the company will be obliged to pay unlawful aid back to the state. However, providing unlawful State aid can lead to a breach of trust between the authorities and companies. Within the EU, the European Commission is obliged to investigate each complaint about alleged unlawful State aid. A complaint can be lodged by a competitor of a beneficiary company, by a local council member of an opposition party or even a member of public. In the Netherlands, for example, it can be observed that local grass-root level organisations use local authorities' ignorance on State aid legislation as a means to attack contested development projects through legal proceedings.

<sup>9</sup> See [http://ec.europa.eu/competition/court/state\\_aid\\_judgments.html](http://ec.europa.eu/competition/court/state_aid_judgments.html)

<sup>10</sup> See [http://ec.europa.eu/competition/state\\_aid/reform/economic\\_assessment\\_en.pdf](http://ec.europa.eu/competition/state_aid/reform/economic_assessment_en.pdf)

<sup>11</sup> Free Trade between Ukraine and the EU: An impact assessment, International Centre for Policy Studies, Kyiv, 2007. P. 191-199.





## EIPA Briefing Note on State Aid Rules EU-Ukraine Association Agreement 2011

### *From legislative approach to implementation*

*It is necessary to focus on implementation of State aid at all levels of government from early on.*

*Without support from higher levels of government, State aid reform can remain a force on paper but powerless in practice.*

Proper organization of legislative work is of course needed.<sup>12</sup> On the other hand, even a successfully completed legislative process does not guarantee that the adopted law will have an effective impact on the real State aid. In order to make use of the benefits of State aid control for the economy, it is necessary to focus on *implementation* of State aid at *all levels of government* from early on. An independent central State aid authority which is entrusted with the powers to control Ukrainian aid measures will surely take care of the monitoring of big aid schemes and obvious forms of State aid like bailout for banks. However, the less obvious State aid measures are often designed locally.

State aid legislation is a complex part of the *acquis*. Comprehensive training of central government and also local authorities' officials will enable them to recognize State aid, especially the less obvious types of aid. State aid is not only a legal issue. Also politicians and public sector managers have to have knowledge of the distortive effects of State aid. Without support from higher levels of government, State aid reform can remain a force on paper but powerless in practice. Besides, politicians are often eager to promise companies benefits, which are contrary to State aid law.

State aid control is really a cross-cutting discipline: it concerns programmes for specific sectors of economy, subsidies for areas like environment, culture, and R&D. Concerning the training and information for civil servants, the focus groups should not be only lawyers and financial controllers. Other priority areas should be included, such as:

- officials working with tax issues/ loans and guarantees,
- public property managers,
- coordinators of public service provision such as public transport or communal housing.

The reason for this is that often, lawyers and financial agents get involved in projects at the stage when policy decisions are already made. The aim should be overall awareness of benefits of State aid control and an ability to recognize potentially unlawful aid. State aid control should also go hand in hand with public procurement since the organization of unfair public procurement might lead to unlawful State aid (e.g. the state does overpay for the service it contracts). Open tender procedures help in preventing State aid.

Experience in the Netherlands has shown that occasional training moments are not enough to successfully implement State aid legislation at all levels of government. Because this is a very complex area of EU law, information and advice is needed permanently. One could think of establishing an organization

---

<sup>12</sup> A project 'Creating a system for monitoring and control of State aid to Ukraine' (2009 till June 2011) deals currently with the legal aspects of state aids.



## EIPA Briefing Note on State Aid Rules EU-Ukraine Association Agreement 2011

which promotes the importance of State aid control and offers officials a free 'help desk function'. It must be supported by a website in a 'clear, simple language' where basic information on State aid is provided and free online consultations (a helpdesk) are available.<sup>13</sup>

*The State aid legislation is not only an external requirement that is relevant for trade with the EU.*

*Also It can be beneficial for the transformation of the Ukrainian economy and public service.*

It is important to stress that the State aid legislation is not only an external requirement that is relevant for trade with the EU. It can be beneficial for the transformation of the Ukrainian economy and public service. State aid control mechanisms increase the efficiency and transparency of public spending, make civil servants better equipped to deal with private business interests and improve the overall business environment, by stimulating fair market conditions in the country.

### ***Responsible institutions and useful resources on topic***

Our more detailed information report on State Aids (Ukrainian and English):

- o European Integration Policy Advice Project – EIPA Project <http://www.nrdevelopment.com/eipa.html>
- o Wider Europe on general EU Ukraine matters <http://www.w-europe.org/?m=20101120>
- o Procurement Systems in Ukraine with the EU Standards” <http://competitionproject.org.ua/>

Specialist information (English):

- o UK Department for Business, Innovation and Skills for general business issues: <http://www.bis.gov.uk/>
- o BIS State Aid Branch has lead responsibility within UK government for co-ordination and development of State Aid policy <http://www.bis.gov.uk/policies/europe/state-aid>

The [website of the European Commission](#)

- o Begunski, L., 'Creating a system for monitoring and control of State aid to Ukraine', Kiyiv, 2010

Specialist information (Ukrainian):

- o Government of Ukraine <http://www.kmu.gov.ua/control/>  
Government of Ukraine. Press-release about adoption of the Concept of the State Aid Reform in Ukraine [http://www.kmu.gov.ua/control/publish/article?art\\_id=243285610](http://www.kmu.gov.ua/control/publish/article?art_id=243285610)
- o The Concept of the State Aid Reform in Ukraine <http://zakon1.rada.gov.ua/cgi-bin/laws/main.cgi?nreq=81-2010-%F0>
- o Press-release about amendments to the Concept of the State Aid Reform in Ukraine Прес-реліз про вдосконалення Концепції реформування системи державної допомоги <http://competitionproject.org.ua/en/publications/press-releases/123-stateaidconcept.html>

<sup>13</sup> A Dutch organization '[Europa Decentraal](#)', a local and regional authorities knowledge centre for queries concerning European law and policy operates successfully since 2001 and its work is based on these principles.